Adam Smith at Three Hundred

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Abstract

To celebrate the three hundredth birthday of Adam Smith, I would like to use examples to clarify some misunderstandings about Smith in economics textbooks. Passages from the *Theory of Moral Sentiments* and the *Wealth of Nations* are quoted to explain what Smith had really said.

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I. Introduction

There is no doubt that, on June 5th this year, many fans of economics around the world would like to celebrate the three hundredth birthday of Adam Smith. I do not know what other fans will do, but one way to celebrate Smith's birthday is to clarify misunderstandings about his ideas. But it might seem strange why economists are still not sure what Smith had really said. Should we ask the real Adam Smith to stand up?

A simple answer to this question is that economics is a social science. It is different from the hard sciences, such as mathematics and physics, which usually have exact solutions to their problems. Subject to the complexity of social phenomena, answers to economic problems are often multiple and changing across countries and over time. To understand the theory of an economist, it is better to read his/her books or papers, rather than to read just textbooks or other second-hand articles.

In this article I will use Smith's words to interpret his theories in both the *Wealth of Nations* and the *Theory of Moral Sentiments*. The focus is on the misunderstanding, not on the consensus. The selection of topics is subjective, since my misunderstanding might be your consensus. This is inevitable because economics is not a hard science.

A standard example of the misunderstanding about Smith is like this: "According to traditional economics, free market capitalism will be essentially perfect and stable. There is little, if any, need for government interference…This line of reasoning goes back to Adam Smith."[1] Almost all textbooks of economics have such statement, but this is not the case for Keynes. For example, Keynes had said that (italics original)

> The phrase *laissez-faire* is not to be found in the works of Adam Smith…his attitude towards the Navigation Acts and the usury laws shows that he was not dogmatic. Even his famous passage about "the invisible hand" reflects the philosophy which we associate with Paley rather than the economic dogma of *laissez-faire*…It is not, indeed, until we come to the later works of Bentham…that we discover the rule of *laissez-faire*…adopted into the service of the Utilitarian philosophy…that fixed *laissez-faire* in the popular mind as the practical conclusion of orthodox political economy.[2]

If Keynes were right, then most economics textbooks might misunderstand Smith, and we need to ask the real Adam Smith to stand up! The misunderstandings I would

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[1] George A. Akerlof and Robert J. Shiller, *Animal Spirits*, Princeton University Press, 2009, p. 2.
[2] John Maynard Keynes, *The End of Laissez-Faire*, Hogarth Press, 1926; *The Collected Writings of John Maynard Keynes*, Vol. IX, Cambridge University Press, 1978, pp. 279-280.

like to clarify in this article are as follows. In Section II we discuss why the basis of Smith's economic theory is cost rather than utility, and why economics went astray after Bentham and his followers initiated utilitarianism. Section III argues that it is Smith who proposed the theory of comparative advantage. Ricardo had just made it famous. Section IV discusses the real bills doctrine which has been misunderstood for many years. Section V is about Smith's view of economic development. Section VI is concerned with the cause and effect, a debate between Smith and Hume. Section VII concludes.

II. Cost or Utility?

Probably the word utility was first used by Hume in his *Treatise of Human Nature*,[3] though the idea had been proposed by Bernoulli in 1738,[4] just one year before the publication of the *Treatise*. But it was Bentham who decided to popularize the idea of utility when he was reading the *Treatise* in 1776, as he recalled that (italics original)

> That the foundations of all *virtue* are laid in *utility*, is there demonstrated…For my own part, I well remember, no sooner had I read that part of the work which touches on this subject, than I felt as if scales had fallen from my eyes, I then, for the first time, learnt to call the cause of the people the cause of Virtue.[5]

The idea of utility was later popularized by Bentham's most important pupil James Mill, along with Mill's eldest son John Stuart. The son was not like father in the sense that John Stuart Mill was only a mild admirer of Bentham, and tried to incorporate the quality, not just the quantity, of pain and pleasure into utilitarianism. Nevertheless, the emergence of utilitarianism was unfortunate because it laid foundations of economics on utility instead of cost, the cornerstone of the economics of Smith and Ricardo.

That Smith had emphasized cost is a consensus among economists, but that Smith emphasized utility might be a misunderstanding. In fact, Smith had put utility away in both his books for different reasons. The first time he refused utility was in the *Theory of Moral Sentiments*. Unlike Hume, Smith did not consider utility as a good basis of moral sentiments. As he said in the discussion of the sentiments of approbation:

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[3] David Hume, *A Treatise of Hume Nature*, 1739-1740; Penguin, 1985, p. 350.
[4] Daniel Bernoulli, "Exposition of a New Theory on the Measurement of Risk," *Econometrica*, 1954, 23-36. What Bernoulli used was the Latin *emolumentum*, which was translated into English as *utility*.
[5] Jeremy Bentham, *A Fragment on Government*, 1776; Cambridge University Press, 1988, p. 51.

But still I affirm, that it is not the view of this utility or hurtfulness which is either the first or principal source of our approbation and disapprobation. These sentiments are no doubt enhanced and enlivened by the perception of the beauty or deformity which results from this utility or hurtfulness. But still, I say, they are originally and essentially different from this perception."[6]

Though Smith disagreed with Hume's idea of utility, he accepted Hume's idea of *sympathy*. But there is an additional difference between them: Hume used *judicious spectator*,[7] while Smith used *impartial spectator*. The former means in the common (or average) point of view, and the latter indicates that conscience, families, or close friends have more weights:

Every man…is first and principally recommended to his own care…After himself, the members of his own family…are naturally the objects of his warmest affections…and the affection gradually diminishes as the relation grows more and more remote.[8]

Hume's *judicious spectator* is similar to Bernoulli's *emolumentum medium* or mean utility.[9] But in Smith's world with different social distances, common point of view or mean utility cannot be the basis of moral sentiments. They might be more adequate in describing the interactions of other social animals, such as bees and ants, if it were possible to say that bees and ants had the concept of morality. As Smith had said that

There is another system which attempts to account for the origin of our moral sentiments from sympathy, distinct from that which I have been endeavouring to establish. It is that which places virtue in utility, and accounts for the pleasure with which the spectator surveys the utility of any quality from sympathy with the happiness of those who are affected by it. This sympathy is different both from that by which we enter into the motives of the agent, and from that by which we go along with the gratitude of the persons who are benefited by his actions. It is the same principle with that by which we approve of a well-contrived machine. But no machine can be the object of either of those two last mentioned sympathies.[10]

As to the reason why Smith ignored utility in the *Wealth of Nations*, we must first understand that the basis of his economics is the idea of cost, or *opportunity cost* in a more modern sense. Smith reminded his reader of the distinction between *value in use*

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[6] Adam Smith, *The Theory of Moral Sentiments*, 6th edition, 1790; Liberty Fund, 1982, p. 188.
[7] Hume (1985), p. 632.
[8] Smith (1982), p. 219.
[9] Bernoulli (1954), p. 24.
[10] Smith (1982), p. 327.

(i.e. utility) and *value in exchange* (i.e. price).[11] The nominal price of commodities is measured by money, and the real price by labor (i.e. *labor theory of value*). The price is composed of wage, profit, and rent. Contrary to the 1870s marginal revolutions, the price is equal to cost, not to (marginal) utility. Smith's focus had never been on utility.

Led by Jevons, Menger, and Walras, marginal revolution is still orthodox economic theory. But in Smith's world price is an exchangeable, and therefore measurable value. Though both cost and utility are subjective concepts, it is cost, not utility, which could be objectively measured when commodities are exchanged. Utility is a psychological phenomenon, which cannot be measured by either money or labor. If price were not measurable, then no transactions would happen. This means that price should be equal to cost rather than (marginal) utility.

Ricardo was absolutely right about Smith's distinction between cost and utility. His remarks on this issue would let us doubt why other economists could misunderstand the differences among price, cost, and utility:

> Utility then is not the measure of exchangeable value, although it is absolutely essential to it…Possessing utility, commodities derive their exchangeable value from two sources: from their scarcity, and from the quantity of labor required to obtain them.[12]

Another misunderstanding about Smith is that he proposed laissez-faire or perfect competition. This is untrue if we accept the above quotation of Keynes. But we can reach the same conclusion if we rightly quote Smith's own words:

> When the price of any commodity is neither more nor less than what is sufficient to pay the rent of the land, the wages of the labour, and the profits of the stock employed in raising, preparing, and bringing it to market…The commodity is then sold precisely for what it is worth, or for what it really costs the person who brings it to market.[13]

What Smith said was that price should be equal to (total) cost, which is the sum of *prime cost* (the cost of raising and preparing) and the cost of bringing it to market. In later chapters Smith mentioned that this last cost is mainly concerned with the costs of retail and wholesale transactions. In terms of Coase,[14] they are *transaction cost*.

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[11] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 5th edition, 1789; Modern Library, 1994, p. 31.
[12] David Ricardo, *Principles of Political Economy and Taxation*, 3rd edition, John Murray, 1821, Ch. I.
[13] Smith (1994), p. 62.
[14] Ronald H. Coase, *The Firm, the Market, and the Law*, University of Chicago Press, 1988.

To sum up: Smith rejected the idea of utility in both the *Wealth of Nations* and the *Theory of Moral Sentiments*. In his theory price is equal to (total) cost, which is the sum of prime cost and cost of bringing it to market (or transaction cost, à la Coase). Smith never proposed perfect competition or laissez-faire. The origin of these ideas should go back to Bentham and Walras. Government plays an important role in the theory of Smith, and he had never said that markets are perfect and stable. Keynes did understand Smith, do we?

III. Make or Buy?

According to economics textbooks, the most famous phrase of Smith should be the *invisible hand*. But Smith might not think so. Because it only appeared in the *Wealth of Nations* once, it could not be an important idea according to Smith's own criterion that "I am always willing to run some hazard of being tedious in order to be sure that I am perspicuous."[15]

Though Smith was not tedious and had mentioned invisible hand only once, he had, in the same chapter, used several examples to explain the idea of acquired advantage, the real origin of the *principle of comparative advantage*. The economics textbooks usually state that it is Ricardo who discovered this principle, and Smith's *absolute advantage* is misleading. In fact, absolute advantage is what Smith called *natural advantage*, which he did not recommend. This is a misunderstanding about Smith in economics textbooks. What Smith recommended was *acquired advantage*, which is similar to, but deeper than, the comparative advantage later proposed by Ricardo. Smith's theory was based on the following make-or-buy choice:

> It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy.[16]

But prior to the make-or-buy decision, you must first decide which commodity you would like to produce. This is in turn based on what Smith called *acquired advantage*:

> The taylor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a taylor. The farmer

15 Smith (1994), p. 32.
16 Ibid., p. 485.

attempts to make neither the one nor the other, but employs those different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours…What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom…It is an acquired advantage only, which one artificer has over his neighbour, who exercises another trade; and yet they both find it more advantageous to buy of one another than to make what does not belong to their particular trades.[17]

It is obvious that Smith's acquired advantage is better than Ricardo's comparative advantage because, in the former, advantage (or occupation choice) is endogenously determined, but in the latter, it is exogenously given. Maybe we can say that it is Smith who discovered comparative advantage which is a special case of acquired advantage. This is another misunderstanding about Smith in economics textbooks.

To sum up: Based on a *least-cost principle*, Smith had made economic decisions operational. This means that, from individuals to the society as a whole, the economic agent would like to make decisions with the minimum (total) cost. The principle of comparative advantage, though proposed by Ricardo, was essentially first raised by Smith in terms of the acquired advantage which is better and truer.

IV. Real or Fictitious?

The third misunderstanding about Smith is concerned with the monetary theory. Both Hume and Smith were excellent monetary economists. Hume originated the idea of the *quantity theory of money* in two essays: "Of Money" and "Of Interest."[18] Smith initiated the idea of real bills in the following passage:

When a bank discounts to a merchant a real bill of exchange drawn by a real creditor upon a real debtor, and which, as soon as it becomes due, is really paid by that debtor; it only advances to him a part of the value which it would otherwise be obliged to keep by him unemployed and in ready money for answering occasional demands.[19]

A real bill is contrary to a fictitious one in which the creditor, the debtor, or both of them would be fictitious. Fictitious bills would have harmful effects, as Smith said:

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[17] Ibid., pp. 485-487.
[18] David Hume, *Essays, Moral, Political, and Literary*, 1777; Liberty Fund, 1987, pp. 281-307.
[19] Smith (1994), p. 331.

when the same two persons do not constantly draw and redraw upon one another, but occasionally run the round of a great circle of projectors, who find it for their interest to assist one another in this method of raising money, and to render it, upon that account, as difficult as possible to distinguish between a real and fictitious bill of exchange; between a bill drawn by a real creditor upon a real debtor, and a bill for which there was properly no real creditor but the bank which discounted it, nor any real debtor but the projector who made use of the money. When a banker had even made this discovery, he might sometimes make it too late, and might find that he had already discounted the bills of those projectors to so great an extent that, by refusing to discount any more, he would necessarily make them all bankrupts, and thus, by ruining them, might perhaps ruin himself.[20]

Obviously Smith was concerned with the quality of the bills of exchange (inside money). In the days of Smith, there was no such thing as central banking.[21] But even there was a central bank which issued outside money, the focus of Smith would still be on the quality rather than the quantity of both outside and inside money.

The monetary theories of Smith and Hume were not contradictory to each other, but their emphases were different. Hume focused on money supply and implicitly assumed the long-run neutrality of money. But Smith had a balanced view between money demand and money supply. His focus was on the difference between real bills and fictitious ones, and economic fluctuations are mainly due to the over issuance of the latter. In other words, inside money was the focal point of Smith, but it is outside money to which Hume had paid more attention. The implication for an efficient monetary system is obviously different under these two theories. The problem is how to draw the line between outside money (gold or paper money in Hume's case) and inside money (bank money or bills of exchange in Smith's case).

The term *real bills doctrine* was coined by Mints,[22] but unfortunately he thought it came from the idea of John Law, the originator of the infamous *Mississippi bubble*. Because Friedman had learned monetary theory from Mints, it was no wonder why he interpreted real bills doctrine in the wrong way.[23] Eichengreen was the other scholar misled by Mints. For example, he had said:

That doctrine, developed in the early eighteenth century by, among others, the Scottish

[20] Ibid., p. 340.
[21] Though the Bank of England was established in 1694, it was not on behalf of a central bank until the *Peel's Act* (Bank Charter Act) became legitimate in 1844.
[22] Lloyd W. Mints, *A History of Banking Theory in Great Britain and the United States*, University of Chicago Press, 1945.
[23] Milton Friedman, *The Optimum Quantity of Money and Other Essays*, Aldine, 1969, Ch. 2.

monetary theorist John Law, was intended as a guide to credit creation by the Bank of England…and play a role in the Mississippi Bubble…His real bills doctrine informed the conduct of central bank policy for two centuries and more thereafter.[24]

Law's proposal was, in effect, creating a fictitious bills doctrine. The root of the bubble was that stock dividends of the Mississippi Company were paid by issuing unbacked paper money. This means that there were not real debtors who would have "ready money for answering occasional demands." It is therefore unbelievable that this infamous doctrine had "informed the conduct of central bank policy" for more than two centuries. Misled by Mints, it is no wonder why quantity theorists have been hostile to Smith's real bills doctrine. It is Law's doctrine which should be blamed.

V. Enemy or Friend?

Economics textbooks usually describe Smith's world as a stable and harmonious one. In fact, Smith is not naïve, and the following passage is a good example:

The interest of the dealers… is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it… The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention.[25]

Obviously Smith knew that there are conflicts of interests between different dealers and between dealers and consumers. Businessmen always have incentives to influence the decisions of policy makers. Markets are, therefore, not necessarily stable and harmonious. The fictitious bills dealer mentioned above is another important source of market fluctuations. Both of these examples tell us that Smith was never proposing a stable and harmonious price mechanism, or a perfect market.

Dealers might be enemies to other market participants. But sometimes they became friends. Why could this happen? From the economic development experience of the

[24] Barry Eichengreen, *Hall of Mirrors*, Oxford University Press, 2015, p. 24. Actually the bank to which Law proposed his idea was the Bank of Scotland. There was not the Great Britain in 1705 when Law proposed. Scotland and England were not united until 1707.

[25] Smith (1994), pp. 287-288.

Western Europe since the collapse of the Roman Empire, Smith found that one of the keys to economic growth and development is that *sometimes* enemies of the enemy are friends:

> The burghers naturally hated and feared the lords. The king hated and feared them too; but though perhaps he might despise, he had no reason either to hate or fear the burghers. Mutual interest, therefore, disposed them to support the king, and the king to support them against the lords. They were the enemies of his enemies, and it was his interest to render them as secure and independent of those enemies as he could. By granting them magistrates of their own, the privilege of making bye-laws for their own government, that of building walls for their own defence, and that of reducing all their inhabitants under a sort of military discipline, he gave them all the means of security and independency of the barons which it was in his power to bestow.[26]

Contrary to Hobbes's war of every man against every man,[27] Smith reminded us of the possibility that enemies of the enemy need not be enemy. They could be friends. If this possibility were true, then vicious competition would be replaced by a healthy one. Cooperation, or at least healthy competition, is the basis of economic progress. A society with every man against every man must be unstable and miserable. A society in which every man supports every man might be a utopia. Smith's world is definitely not a utopia, and it is not Hobbesian, either. A perfectly stable and harmonious world is obviously impossible. But Smith tried to tell us that, based on the propensities to exchange and to sympathize, we could live a better life by using markets, and healthy competition is necessary for the market to work properly.

VI. Cause or Effect?

As one of the best friends of Hume, Smith had frequently used Hume's idea about cause and effect. Nevertheless, they had different opinions of causality. For Hume, it is almost impossible for people to get the first cause of anything that happened. This is because you cannot trace back to what had originally happened. There was always something which you just do not know. For Smith, the point is not to find the first cause, but to figure out *enough* reasons to make sense of something you care about. To understand causality, all reasons are needed for Hume, but enough reasons are enough for Smith. The following case of the *sensible knave* is a good example:

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26 Ibid., p. 430.
27 Thomas Hobbes, *Leviathan*, Andrew Crooke, 1651, Ch. XIII.

> The industrious knave cultivates the soil; the indolent good man leaves it uncultivated. Who ought to reap the harvest? Who starve, and who live in plenty? The natural course of things decides it in favour of the knave: the natural sentiments of mankind in favour of the man of virtue…human laws, the consequences of human sentiments.[28]

The choice between the industrious knave and the indolent good man seems to be a dilemma, when we have to decide who ought to reap the harvest. If we just know who is good or bad, without knowing who is more industrious, then the decision is simpler. Of course, there is the dilemma if getting those personal information is costless. But if there were information costs, then we have to make a decision under the condition of imperfect information. When only enough information is available and decisions must be made, it is the idea of Smith, instead of Hume, which would be more helpful, as reflected in the following paragraph of Smith:

> The sentiments or affection of the heart from which any action proceeds, and upon which its whole virtue or vice must ultimately depend, may be considered…in relation to the cause which excites it…or the effect which it tends to produce…in the proportion or disproportion which the affection seems to bear to the cause…consists the propriety or impropriety…of the consequent action. In the beneficial or hurtful nature of the effects which the affection aims at, or tends to produce, consists the merit or demerit of the action, the qualities by which it is entitled to reward, or is deserving of punishment.[29]

And because of the irregularity of human sentiments, we are not interested in pursuing the first cause of what happened. This makes Smith's idea of causality more useful than that of Hume in explaining facts in the real world. As Smith said:

> Nature, however, when she implanted the seeds of this irregularity in the human breast, seems…to have intended the happiness and perfection of the species…That necessary rule of justice, therefore, that men in this life are liable to punishment for their actions only, not for their designs and intentions, is founded upon this salutary and useful irregularity in human sentiments concerning merit or demerit…Nor is that irregularity of sentiments altogether without its utility…Man was made for action…he may call forth the whole vigour of his soul…to produce those ends which it is the purpose of his being to advance…neither himself nor mankind can be fully satisfied with his conduct…unless he has actually produced them.[30]

Not only in the *Theory of Moral Sentiments* that Smith discussed cause and effect,

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[28] Smith (1982), p. 168.
[29] Ibid., p. 18.
[30] Ibid., pp. 105-106.

but in the *Wealth of Nations* there were other examples, one of which is the discussion of the cause and effect of price changes.

> High or low wages and profit, are the causes of high or low price; high or low rent is the effect of it. It is because high or low wages and profit must be paid, in order to bring a particular commodity to market, that its price is high or low. But because its price is high or low; a great deal more, or very little more, or no more, than what is sufficient to pay those wages and profit, that it affords a high rent, or a low rent, or no rent at all.[31]

This paragraph is very important because it is the key to understanding inflation. If the cost of labor and capital (i.e. wages and profit) rises, then you must transfer some of the cost to the customer. This means that the price of your commodity would rise. But this does not necessarily mean that the rent of your store (if you do not own it) would also rise. It depends on whether the demand for your commodity would rise enough for you to cover the necessary costs of wages and profit. But without those labor and capital, your commodity could not be produced. This is why Smith had said that wages and profit are the cause of the price change, and the rent is the effect of it.

VII. Conclusions

In this article I have tried to use the words of Smith to clarify some ambiguities and misunderstandings about Smith in economics textbooks. There must be many others I do not mention here, but I think that examples in the present article might be enough to ask the real Adam Smith to stand up.

Perhaps there will never be a consensus about what the real Adam Smith would be. After all, economics is not a hard science, and there is no hard evidence for most, if not all, economic problems. But one thing for sure is that misunderstandings about Smith will never make economics less interesting or important for the real admirer of Adam Smith.

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[31] Smith (1994), p. 168.